

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: Nakanishi Analyst: Scott McFarlane Bill Number: ABX1 4
Related Bills: See Legislative History Telephone: 845-6075 Introduced Date: September 18, 2007
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Health Savings Account (HSA) Deduction Conformity

SUMMARY

This bill would allow the same deduction on California personal income tax returns for contributions to an HSA as is allowed on the federal individual income tax return for the same taxable year.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to conform to the federal HSA provisions to simplify the preparation of California individual income tax returns.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and specifically operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSISFEDERAL/STATE LAW*Health Savings Accounts*

Under federal law, individuals with a high deductible health plan (HDHP), and no other health plan other than a plan that provides certain permitted coverage, may establish a health savings account (HSA). In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.

Board Position:

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Department Director

Date

Selvi Stanislaus

11/8/07

Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual in determining adjusted gross income (i.e. "above-the-line"). Contributions to an HSA are excludable from income and employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10%. The 10% additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100% of the annual deductible under the HDHP,¹ or (2) (for 2007) \$2,850 in the case of self-only coverage and \$5,650 in the case of family coverage.² Contributions in excess of the maximum contribution amount are generally subject to a 6% excise tax.

Health Flexible Spending Arrangements and Health Reimbursement Arrangements

Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health flexible spending arrangements (FSAs) and health reimbursement accounts (HRAs). Health FSAs typically are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, then the compensation that is foregone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide deferred compensation. This requirement often is referred to as the "use-it-or-lose-it rule."

HRAs operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis, and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year. Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA.

Subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

¹ The limits are indexed for inflation. For 2006, a high deductible plan is a health plan that has a deductible that is at least \$1,050 for self-only coverage or \$2,100 for family coverage and that has an out-of-pocket expense limit that is no more than \$5,250 in the case of self-only coverage and \$10,500 in the case of family coverage.

² These amounts are indexed for inflation.

Tax Relief and Health Care Act (TRHCA) of 2006 (Public Law 109-432), enacted December 20, 2006

Starting in 2007, the TRHCA made the following six changes to HSAs:

1. FSA and HRA Terminations to Fund HSAs

Certain amounts in a health FSA or HRA are allowed to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006, or (2) the balance in the health FSA or HRA as of the date of the distribution.

2. Repeal of Annual Deductible Limitation on HSA Contributions

Limits on the annual deductible contributions that can be made to an HSA are modified so that the maximum deductible contribution is not limited to the annual deductible under the HDHP. Thus, starting in 2007, the maximum aggregate annual contribution that can be made to an HSA is \$2,850 (for 2007) in the case of self-only coverage and \$5,650 (for 2007) in the case of family coverage.

3. Modification of Cost-of-Living Adjustment

In the case of adjustments made for any taxable year beginning after 2007, the Consumer Price Index for a calendar year is determined as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under present law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the high-deductible health plan requirements).

4. Contribution Limitation Not Reduced for Part-Year Coverage

In general, starting in 2007, individuals who become covered under a high deductible plan in a month other than January are allowed to make the full deductible HSA contribution for the year rather than, as under prior law, being required to prorate the deduction based on the number of months the individual was enrolled in a HDHP.

5. Exception to Requirement for Employers to Make Comparable Health Savings Account Contributions

Enacts an exception to the comparable contribution requirements to allow employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. For example, an employer is permitted to make a \$1,000 contribution to the HSA of each nonhighly compensated employee for a year without making contributions to the HSA of each highly compensated employee.

6. One-Time Distribution from Individual Retirement Plans to Fund HSAs

Allows a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement (IRA). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under these rules are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 10% additional tax on early distributions.

Current California Law

California has not conformed to any of the federal HSA provisions. The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking an HSA deduction on the federal individual income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Any contribution to an HSA, including salary reduction contributions made through a cafeteria plan, made on the employee's behalf by their employer is added to AGI on the employee's California return.

Although California has not conformed to HSAs, California law is conformed to the federal rules for Archer medical savings accounts (MSAs) and allows a deduction equal to the amount deducted on the federal return for the same taxable year. California imposes a 10% additional tax rather than the 15% additional federal tax on distributions from an MSA not used for qualified medical expenses.

Because a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer's California return and as that MSA distribution is not treated as being made for qualified medical expenses it would, therefore, be subject to the MSA 10% additional tax.

Additionally, a federal tax-free qualified HSA funding distribution is not allowed under California law because California specifically does not conform to Internal Revenue Code (IRC) section 223, relating to HSAs, even though California conforms to IRC section 408, relating to IRAs. Under California law, any distribution from an IRA to an HSA must be added to AGI on the taxpayer's California return and would be subject to a 2 ½% additional tax under the rules for premature distributions under IRC section 72.

THIS BILL

Starting with taxable year 2008, this bill would conform to the federal HSA provisions in effect for 2006, as follows:

1. Allows the same above-the-line deduction for contributions to an HSA by or on behalf of an individual and adopts the rules applicable to the trust itself in order for the trust to be exempt from tax. In addition, the disqualified distribution penalty applicable to HSAs is modified for California purposes to be 2 ½% instead of the federal rate of 10% to be consistent with the other California penalty provisions applicable to IRAs. Consistent with general conformity policy in other areas, the federal 6% excise tax on excess contributions and the federal estate tax provisions are not being conformed to by this bill.

2. Allows the same exclusion from an employee's gross income for the amount of any contributions to an HSA (including salary reduction contributions made through a cafeteria plan) made on the employee's behalf by their employer.
3. Allows rollovers from MSAs to be made to HSAs, as well as rollovers between HSAs, without penalty.
4. Adopts the same \$50 penalty for failure to make required reports.
5. Allows certain amounts in health FSAs or HRAs to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements.
6. Conforms to repeal of annual deductible limitation on HSA contributions.
7. Determines the Consumer Price Index for a calendar year as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under prior law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the HDHP requirements).
8. Allows individuals who become covered under a high deductible plan in a month other than January to make the full deductible HSA contribution for the year rather than being required to prorate the deduction based on the number of months the individual was enrolled in an HDHP.
9. Conforms to an exception to the comparable contribution requirements to allow employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. For example, an employer is permitted to make a \$1,000 contribution to the HSA of each nonhighly compensated employee for a year without making contributions to the HSA of each highly compensated employee.
10. Allows a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement (IRA). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under these rules are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 2½% additional tax on early distributions.

LEGISLATIVE HISTORY

SB 25 (Maldonado and Runner, 2007/2008) is nearly identical to this bill except that conformity to the federal HSA provisions would apply starting with tax year 2006 and amended returns would be allowed. That bill was held in the Senate Revenue and Taxation committee.

AB 84 (Nakanishi/Smyth, 2007/2008) is identical to this bill. That bill was held in the policy committee.

AB 142 (Plescia, 2007/2008) is nearly identical to this bill, except that conformity to the federal HSA provisions would apply starting with tax year 2007. That bill was held in the Senate and Revenue Taxation Committee.

AB 245 (DeVore, 2007/2008) is identical to AB 142. That bill was held in the Assembly Committee on Revenue and Taxation.

SB 1584 (Runner and Ackerman, 2005/2006) would have retroactively conformed to the federal HSA provisions starting with tax year 2004 and would allow amended returns to be filed. That bill was held in the Senate and Revenue Taxation Committee.

SB 173 (Maldonado, 2005/2006) was nearly identical to this bill, except that conformity to the federal HSA provisions would apply starting with tax year 2006. That bill was held in the Senate and Revenue Taxation Committee.

SB 1787 (Ackerman, 2005/2006) would have retroactively conformed to the federal HSA provisions starting with tax year 2004 and would allow amended returns to be filed. That bill was held in the Senate and Revenue Taxation Committee.

AB 661 (Plescia, 2005/2006) was nearly identical to this bill, except that conformity to the federal HSA provisions would apply starting with tax year 2006. That bill was held in the Assembly Committee on Revenue and Taxation.

AB 2010 (Plescia, 2005/2006) was nearly identical to this bill except that conformity to the federal HSA provisions would apply starting with tax year 2007. That bill was held in the Assembly Committee on Revenue and Taxation.

AB 2315 (Maldonado/ Nakanishi, 2003/2004), as amended May 17, 2004, was nearly identical to this bill, except that the federal HSA provisions would apply starting with tax year 2006. That bill was held in the Assembly Committee on Appropriations.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* does not impose a personal income tax so a comparison to Florida is not relevant. *Illinois, Massachusetts, Michigan, Minnesota, and New York* conform to the federal deduction for contributions to HSAs.

FISCAL IMPACT

The bill would not significantly impact the department's cost.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact for ABX1 4 Effective with Taxable Years BOA 1/1/08 (\$ in Millions)		
2008-09	2009-10	2010-11
-\$27	-\$32	-\$46

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Please note that even though this bill is identical to AB 84 as amended March 12, 2007, the revenue impact is revised. The differences in the revenue estimates are summarized below:

- There is no longer a revenue impact to 2007-08.
- The \$2 million revenue loss that under AB 84 is projected to impact 2007-08 is shifted to 2008-09.
- The HSA provisions of the TRHCA of 2006 increase the estimated revenue loss for taxable year 2008 by \$2.2 million.
- The \$1 million revenue loss from the rollover of Archer MSA's that under AB 84 is projected to impact 2008-09 is shifted to 2009-10.

The revenue impact of the bill would be determined by (1) the amount of contributions to HSAs deducted on tax returns, (2) the amount of contributions to HSAs made on behalf of employees (including salary reduction contributions), (3) the amount of funds in Archer medical savings accounts rolled over to HSAs, and (4) the result of conforming to the expanded HSA provisions included in the TRHCA of 2006 and marginal tax rates of taxpayers deducting or excluding such contributions.

1. For the 2004 taxable year, tax return data indicates 7,500 returns reflected HSA adjustments on Schedule CA, California Adjustments, totaling \$20 million. This means that these taxpayers made tax-deductible contributions for federal purposes that were reversed for state purposes. Recent articles indicate the number of HSAs nationwide doubled during 2005 and again in 2006. To derive the estimates, this substantial growth rate is used through 2007 and is decreased thereafter to more sustainable rates. For 2008, contributions by California individual taxpayers to HSAs are estimated at \$235 million. Applying a marginal tax rate of 7% results in a revenue loss of \$16.4 million (\$235 million x 7% = \$16.4 million).

2. Contributions made by an employer on behalf of an employee (including salary reduction contributions made through a cafeteria plan) cannot be identified on a tax return. It is not known how many additional HSAs may exist as a result of this contribution arrangement. Data indicate that 6% of employers offer HSA-eligible HDHPS. It is believed that most of these employers pay the premium for the HDHP rather than contribute to the employee's HSA. The rationale is that the premium is often less than the amount of the deductible that can be contributed to the HSA. Also, HSA balances are portable and not owned by the employer. For purposes of an estimate, it is assumed that employer contributions on behalf of an employee are approximately one-fourth of that by individuals, or \$59 million in 2008 ($\$235 \text{ million} \times 25\% = \59 million). Applying a marginal tax rate of 7% results in an additional revenue loss of \$4.1 million for 2008 ($\$59 \text{ million} \times 7\% = \4.1 million).
3. The following is the estimate for the potential rollover of balances in Archer MSAs. For the 2002 taxable year, tax return data indicate deductible MSA contributions totaling \$11.6 million reported on 4,600 returns. It is possible that balances in some MSAs have already been rolled over. In addition, there is no requirement that balances must be rolled over. It is assumed that half of these accounts ($4,600 \times 50\% = 2,300$) would be rolled over and each account has an average balance of \$6,250. This balance equates to two-and-a-half years of average contributions ($2.5 \text{ years} \times \$2,500 \text{ average annual contribution} = \$6,250$). Applying a marginal tax rate of 7% results in a loss of an additional \$1 million ($2,300 \times \$6,250 \times 7\% = \1.0 million). It's anticipated that rollovers would likely occur in the initial one or two years of conformity. Therefore, assuming enactment after September 20, 2007, the \$1 million loss is divided between 2009 and 2010, or \$0.5 million each taxable year.
4. For expanded HSA provisions included in the TRHCA of 2006, estimates are based on a proration of federal estimates developed for the act. For these provisions, the conformity estimate is an additional loss of \$2.2 million for the 2008 taxable year.

For taxable year 2008, the estimated loss is \$23 million ($\$16.4 \text{ million} + \$4.1 \text{ million} + \$2.2 \text{ million} = \22.7 million). Tax year estimates are converted to the cash flow fiscal year revenue estimates reflected in the table. For example, the 2008-09 revenue loss of \$27 million consists of \$23 million for the 2008 taxable year and \$4 million for the 2009 taxable year.

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